Catholic University Law Review

Volume 20
Issue 3 *Spring 1971*

Article 7

1971

The Deductibility of Pre-Incorporation Expenses

Wendell W. Wiener

Comment

The Deductibility of Pre-Incorporation Expenses

After a corporation has been organized and has engaged in business operations, expenses incurred for salaries, travel and entertainment, consulting fees, legal and accounting fees, marketing surveys, and other similar current expenditures are deductible if "paid or incurred during the taxable year in carrying on any trade or business."[1]

This comment is concerned with the deduction by recently formed corporations of expenses incurred prior to incorporation. These pre-incorporation expenses are virtually the same as those incurred by a corporation operating as a going concern. Thus the distinction between pre-incorporation expenses and expenses is one of timing rather than classification.

Pre-incorporation expenses may be incurred by individuals acting as promoters of the new venture or by a predecessor unincorporated entity, such as a partnership or joint venture. While pre-incorporation expenses may well affect the individuals who initially pay these expenses, this comment will focus on the deductibility of such expenses to the corporation.[2]

There are two aspects to the deductibility of pre-incorporation expenses. Both center around the statutory tests for trade or business deductions as provided in Section 162 of the Internal Revenue Code.[3] First, pre-incorporation expenses must be paid or incurred during the taxable year and second they must be paid or incurred in carrying on a trade or business.

Meeting the Test of Paid or Incurred During the Taxable Year

In determining whether expenses are "paid or incurred during the taxa-

1. INT. REV. CODE of 1954, § 162(a) [hereinafter cited as IRC]. Section 162 also establishes other tests not related to the question of pre-incorporation expenses.
2. *See* Fleischer, *The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment*, 14 TAX L. REV. 567 (1959), for a discussion of the problems related to individuals who incur expenses incident to the formation of new business ventures.
3. IRC § 152.

able year," consideration should be given to accounting periods, corporation income tax returns, de facto corporations, the special statutory provision covering organization expenses, and transfers of property to corporations controlled by the transferors. These considerations relate to the definition of "taxable year"—a matter of timing—or provide ways to alleviate the restrictions of the taxable year through capitalization of amortizable assets with subsequent periodic deductions.

Timing: The Taxable Year

The key to the timing problem in deducting pre-incorporation expenses is the taxable year. This is the time span when current expense deductions are claimed against gross income.[4] Section 441 defines the taxable year as "the taxpayer's annual accounting period, if it is a calendar year or a fiscal year . . . ."[5] If the taxpayer's return is for less than 12 months, then the taxable year is the period for which the return is made.[6]

Section 443 provides: "A return for a period of less than 12 months . . . shall be made . . . . [w]hen the taxpayer is in existence during only part of what would otherwise be his taxable year."[7] The Income Tax Regulations give an example of the applicability of Section 443 to new corporations:

> If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a corporation organized on August 1 and adopting the calendar year as its annual accounting period, is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter.[8]

Sections 441 and 443 together with the Regulations, indicate that a new corporation's taxable year begins when the corporation comes into existence. The Regulations assume that the corporation comes into existence on the date it is organized.[9]

Although neither the Code nor the Regulations so specify, it may be inferred that the law of the state of incorporation determines the beginning of

4. *Id.* § 441(a). A taxable year cannot extend beyond twelve months. *See* I.T. 3466, 1941-1 CUM. BULL. 238, where a corporation incorporated on November 3, 1939, was not allowed to file its first return for the fiscal year ending November 30, 1940. Even though the organization of the corporation was perfected on December 18, 1939, the return was invalid because it covered more than twelve months.

5. IRC § 441(b)(1).

6. *Id.* § 441(b)(3).

7. *Id.* § 443(a)(2).

8. Treas. Reg. § 1.443-1(a)(2) (1960). *See* Treas. Reg. § 1.6012-2 (1958) for corporation income tax return filing requirements for short period returns.

9. Treas. Reg. § 1.443-1(a)(2) (1960).

corporate existence. For example, the Delaware General Corporation Law declares:

> Upon the filing with the Secretary of State of the certificate of incorporation, executed and acknowledged in accordance with section 103, the incorporator or incorporators who signed the certificate, and his or their successors and assigns, shall, from the date of such filing, be and constitute a body corporate, by the name set forth in the certificate . . . .[10]

Applying the Regulations to new Delaware corporations, it appears that the initial tax return would include only those transactions entered into after filing the certificate of incorporation. This illustrates the major point underlying both the Code and the Regulations concerning the initial taxable year and the first return: a corporation cannot begin its initial accounting period prior to its existence and cannot claim deductions incurred before incorporation.

De facto Corporations—Looking Behind the Date of Incorporation

Although the Code and the Regulations seem to look to the incorporation date as the beginning of the initial accounting period, at least two cases have ignored this date to allow deductions for pre-incorporation expenses.

In *Camp Wolters Land Co. v. Commissioner,*[11] prior to the date of incorporation, promoters acquired land and leased it to the United States for use as an Army camp. The promoters, who incurred expenses in demolishing a building on the land several months before its transfer to the new corporation, deducted the expenses on the corporate return. Reversing the Tax Court, the Fifth Circuit Court of Appeals held that the corporation adopted the contracts made by the promoters:

> [E]ven though at the time of the acquisition of the deeds and leases and the other contracts by the incorporators of taxpayer, there was no fully born corporation in being and in consequence the title to the property thus acquired vested in the incorporators instead of the corporation, such incorporators would hold title in trust as constructive trustees who could be compelled to convey the title to the corporation upon its coming into lawful being. . . .
>
> The income derived from the property so purchased or leased by the incorporators for the taxpayer was also held in trust for the corporation to be formed. Income from the property should ordinarily go to him who is the beneficial or real owner and income taxes ought to be laid against him who owns the income. Since the corporation was the beneficiary of the income so held in trust

10. DEL. CODE ANN. tit. 8, § 106 (1968).
11. 160 F.2d 84 (5th Cir. 1947), *rev'g* 5 T.C. 336 (1945).

> for it, and since the law allows certain deductions and losses incurred in the production of such income, the taxpayer here was entitled to such deductions as would have been available to it had it been duly and legally incorporated prior to any of the transactions by its incorporators under consideration here.[12]

The *Camp Wolters* holding is limited, however, because it deals with a demolition loss, which the court permitted to be amortized and deducted ratably over the life of the government lease. This deduction differed from the usual Section 162 "ordinary and necessary [business] expenses," because it was an abandonment loss and because it was allowed to be amortized over a period beyond the year in which the loss occurred.

The apparent limitations of *Camp Wolters* did not prevent the Tax Court from later applying its rationale to current expenses. In *Canal Navigation & Trading Co.*,[13] the Tax Court permitted the corporation to deduct compensation paid for services rendered by its officers prior to the date of incorporation:

> We understand from *Camp Wolters Land Co. v. Commissioner* . . . that the corporation is "entitled to such deductions as would have been available to it had it been duly and legally incorporated prior to any of the transactions by its incorporators."[14]

The *Camp Wolters* and *Canal Navigation & Trading* decisions have been described as holding the de facto corporations which begin to do business through their officers and promoters may claim deductions for expenses incurred during the period prior to formal incorporation.[15] *Camp Wolters* has also been interpreted as holding that "[i]f a *de facto* corporation attains *de jure* status during a taxable year, it is probably to be treated as a single taxpayer for the entire period."[16]

Obligations for Contracts Made Prior to Incorporation

The *Camp Wolters* decision was based in part on Texas authority which indicated that corporations might expressly or impliedly adopt the contracts of

---

12. *Id.* at 88. *Cf.* Myrtus Corp. v. Commissioner, 138 F.2d 743 (5th Cir. 1943), in which the court found that pre-incorporation income arising from the acts of a bondholders' committee which purchased the assets of an insolvent corporation and leased the purchased assets, was taxable to a new corporation to which the lease was assigned. The court treated the advance rental received by the committee prior to the date of incorporation as taxable to the corporation on the theory that it received the benefits of the lease assigned to it.

13. 6 CCH Tax Ct. Mem. 909 (1947), *aff'd*, 168 F.2d 512 (5th Cir. 1948).

14. *Id.* at 912.

15. Weissman, *Allowable Deductions on the Formation, Reorganization and Liquidation of a Corporation*, 53 Nw. U.L. Rev. 681, 692 (1959).

16. B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 39 (2d ed. 1966).

their promoters at the time of organization.[17] The application of the substantive corporate law of the state of incorporation seems fair. A court hearing a tax case should not ignore state rules which require corporations to uphold pre-incorporation contracts. If a court ignores state law requiring corporations to honor pre-incorporation obligations, the corporation would have to shoulder the burden of promoters' contracts without the tax benefit of deductions for related pre-incorporation expenses.

An example of a state law which recognizes the possibility of promoters making contracts on behalf of their to-be-formed corporations is the Michigan statute:

> No contract made by the incorporators for or on behalf of any corporation to be formed preliminary to the filing of the articles shall be deemed to be invalid or ineffectual because made prior to such filing, and all property held by such incorporators for the benefit of the proposed corporation shall be deemed to be the property of such corporation.[18]

Predecessor Businesses—The Timing Problem Solved by Judicial Allocation

Pre-incorporation expenses may be incurred by non-corporate predecessor businesses which later choose to incorporate. These expenses appear unrelated to the business of the new corporation because they have been incurred by the predecessor non-corporate entity. The cases dealing with this situation suggest that the date of incorporation will determine the cutoff date of the previous entity's business activity and will govern the allocation of income and expenses between that entity and the new corporation.

In *Florida Grocery Co.*[19] the business began on an unincorporated basis in October 1916. On April 17, 1917, the corporation was chartered. On May 28, 1917, stock was issued and a bill of sale executed by the individuals who owned the unincorporated business, transferring its assets to the corporation. The Board of Tax Appeals held that the business operated as a joint venture from January 1, 1917, to May 28, 1917, and should be taxed as a corporation from May 28, 1917, to the end of the calendar year.

In *Peter W. Rouss*[20] the Board, in holding that a newly formed corporation was liable for income tax for the period beginning with its date of incorporation on May 13, 1918, rejected the argument that the corporation, in-

17. *See* 10 TEX. JUR. *Corporations* § 12 (1930).
18. MICH. COMP. LAWS ANN. § 450.8 (1967).
19. 1 B.T.A. 412 (1925).
20. 4 B.T.A. 516 (1926), *sustained,* unreported opinion D.C.N.Y., *aff'd,* 30 F.2d 628 (2d Cir.), *cert. denied,* 279 U.S. 853 (1929).

stead of the individual taxpayer, should be liable for tax on the net income for the unincorporated period of that year by saying:

> We can not agree with the taxpayer that he [in his capacity as an individual] is relieved from income tax in respect of the profits to May 13, 1918, simply because he failed to take an inventory as of that date. If there were any profits they are chargeable with income tax. Our problem is simply to determine the amount of the income from the business, if any, from January 1 to May 13, 1918.[21]

In *Coddington v. Commissioner*[22] a going concern was transferred to a newly-formed corporation based on balances in its business books as of July 1, 1919. The date of incorporation was August 18, 1919. The income of the business, net of deductions, for all of July and part of August was allocated from the corporation to the individual taxpayers. The Board of Tax Appeals declared:

> We have been unable to find in this record anything which we can construe into either the declaration of a trust in favor of the petitioner and his associates or the effect of producing an association between them covering the period from July 1 to August 18 or 22 in respect to the ownership of the gains and profits produced by the business and property ultimately turned over to the corporation on August 22, 1918.[23]

Although *Coddington* rejected the taxpayer's argument for the existence of a trust, the Fifth Circuit later applied the trust theory to the actions of the promoters of the *Camp Wolters* corporation.[24]

A more recent decision, *United States Asiatic Co. v. Commissioner*,[25] also denied the corporation deductions for pre-incorporation expenses which related to a pre-existing business. The Tax Court held:

> During all of the above-mentioned periods, the petitioner corporation was not in existence, either *de facto* or *de jure*. Thus, there is no warrant whatever for its attempt to accrue and deduct, as expenses of carrying on its own business after incorporation, salary to [a promoter or incorporator] for preceding periods when he could not possibly have been either an officer or employee of the corporation, and business expenses which had been incurred and paid by [a promoter or incorporator] during said preceding periods when he was operating either as a joint venturer or as a sole proprietor.[26]

21. *Id.* at 519.
22. 10 B.T.A. 712 (1928).
23. *Id.* at 715-16.
24. 160 F.2d 84 (5th Cir. 1947).
25. 30 T.C. 1373 (1958).
26. *Id.* at 1380.

These cases indicate that a corporation may not deduct pre-incorporation expenses which cannot be proven to benefit the business of the new corporation. Characteristically, the denied expenses did not relate to the "carrying on" of the corporate business, but were only for the benefit of the predecessor enterprise. The *Camp Wolters* and *Canal Navigation & Trading* cases are distinguishable since they upheld deductions of pre-incorporation expenses which were of benefit to the new corporation alone. Thus, pre-incorporation expenses may be deducted by the new corporation if the deductions do not relate to a prior enterprise and are incurred solely for the benefit of the new entity.

Limited Statutory Recognition of Pre-Incorporation Expenses—Organization Expenses

In addition to the possiblity of relying on case law for deducting pre-incorporation expenses, the taxpayer may look to the Internal Revenue Code for specific relief in the limited area of organization expenses.

Pre-1954 Treatment

Early Board of Tax Appeals cases held that expenditures to create the corporation were not deductible because they were capital expenditures.[27] The Tax Court continued the approach of requiring the capitalization of organization expenses.[28]

The items required to be capitalized in the pre-1954 cases were primarily legal fees. However, in *Guarantee Bond & Mortgage Co. v. Commissioner*[29] a deduction was denied to the corporation for stock issued in payment for financial planning and management services. And in *Recreation Co. v. Commissioner*,[30] a deduction was denied to a corporation for services rendered chiefly in aid of the petitioner's capital structure.

Section 248—Amortization of Organization Expenses

In 1954 Section 248 was enacted and permitted the amortization of organization expenses for the first time. An organization expense is an expenditure which:

(1) is incident to the creation of the corporation;
(2) is chargeable to the capital account; and

---

27. *See, e.g.*, W.P. Brown & Sons Lumber Co., 26 B.T.A. 1192 (1932); Udolpho Wolfe Co., 15 B.T.A. 485 (1929).
28. *See, e.g.*, Warner Mountains Lumber Co., 9 T.C. 1171 (1947), *acquiesced in*, 1948-2 CUM. BULL. 4.
29. 14 B.T.A. 1015 (1929), *aff'd*, 44 F.2d 297 (6th Cir. 1930).
30. 15 B.T.A. 757 (1929).

(3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.[31]

The Regulations indicate that "expenditures connected with the issuance or selling of shares of stock or securities" are not organizational expenses.[32] Presumably the reason for not including these expenses is that they relate not to the creation of the corporation but to its capital structure. The kinds of organization expenses which the Regulations do allow include the usual accounting and legal fees necessary to the formation of the corporation. The statutory authority incident to the creation of the corporation shown in (1) above should be liberally interpreted to include more than accounting and legal fees because organization expenditures often include such things as salaries paid or incurred for services rendered by promoters and future officers, office rent, travel expenses, and supplies.

There is an absence of cases after 1954 either allowing or disallowing the amortization of organizational expenses beyond accounting and legal services. This absence of litigation could be interpreted as an optimistic sign that financial planning (not of a kind related to the raising of capital) and management advisory expenses are being considered incident to the creation of the corporation and are, therefore, amortizable. However, in view of the narrow interpretation shown in the Regulations and the absence of case law, Section 248 might be a weak reed on which to rely for support in deducting pre-incorporation expenses which fall outside the defined categories.[33]

Deductions for Liabilities Assumed by the New Corporation in Section 351 Transactions

Section 351 permits the non-recognition of gain upon the transfer of property to a corporation in exchange for stock.[34] The transfer of liabilities related to the property generally will not result in the recognition of gain to the transferor.[35] Consequently, it is common for owners of predecessor businesses to transfer liabilities which arose prior to the transfer (and usually prior to the date of incorporation) to the new corporation. This practice has received judicial attention as evidenced by the following cases.

---

31. IRC § 248(b).
32. Treas. Reg. § 1.248-1(b) (1956).
33. *Cf.* Weissman, *supra* note 15 at 701, wherein he suggests that the value of stock issued for services should be includible as an organizational expense under Section 248.
34. IRC § 351.
35. *Id.* § 357(a). *But see* IRC § 357(b) and (c).

In *Holdcroft Transportation Co. v. Commissioner*[36] a deduction was denied to a corporation which had assumed a contingent liability of a predecessor partnership on the ground that the contingent liability "did not arise out of the operation of the business" of the corporation. The court held that the payment of the contingent liability by the corporation was not an operating expense or loss of the incorporated business but should be treated as part of the acquistion cost of the property from the partnership.[37] Although the court did not determine whether any portion of the disallowed deduction could be added to the basis of the depreciable property, Section 351 limits the transferee's basis to that of the transferor.[38]

In *Doggett v. Commissioner*[39] an individual on the cash basis of accounting transferred his business to a newly formed corporation. The individual was denied deduction of expenses incurred prior to the date of incorporation but actually paid by the new corporation. In denying the deduction the court said:

> To the extent these payables arose out of the business they should be deductible by someone, but the taxpayer, an individual on the cash basis, is met with the objection that he did not pay them.
>
> Perhaps he could have provided for the payment in due course of these payables by the corporation as his agent, but he did not do that. What he might have done is not so important as the fact that he did not commit himself at the time. To reserve the right, after the event, advisedly, if advised at all, to attribute the deduction to the corporation or to its sole stockholder, offends notions of justice in taxation. That one or the other should be allowed to claim the deduction, therefore, does not require the conclusion that the individual cash basis taxpayer, who chose to transfer the obligation without payment, is now entitled, as a matter of law, to claim what he did not then claim unequivocally.[40]

While the *Doggett* decision did not discuss the possible deduction of the disallowed expenses by the corporation, it is possible that under the *Holdcroft* rule, they would not be deductible by the corporation but treated as part

---

36. 153 F.2d 323 (8th Cir. 1946), *aff'g* CCH Tax Ct. Mem. 508 (1945). *See* Cropper, *Tax Problems of Accounts Payable and Receivable Upon Incorporating a Cash Basis Taxpayer*, 6 SANTA CLARA LAWYER 216 (1966), for a discussion of *Holdcroft* and other related decisions.

37. *See also* Athol Mfg. Co. v. Commissioner, 54 F.2d 230 (1st Cir. 1931), where a corporation was denied deduction for expenses (1) attributable to a predecessor corporation, and (2) resulting from the assumption of the predecessor's liabilities by Athol. The court held that the payment of the expenses were part of the purchase price of the assets of the predecessor and constituted a capital, not a business expenditure.

38. *See* IRC §§ 351(e)(2), 362(a).

39. 275 F.2d 823 (4th Cir. 1960), *aff'g* 17 CCH Tax Ct. Mem. 873 (1958), *cert. denied*, 364 U.S. 824 (1960).

40. *Id.* at 827.

of the acquisition cost of the assets. The noteworthy aspect of the *Doggett* case is the dictum: "one or the other should be allowed to claim the deduction."

In *Arthur L. Kniffen*[41] a cash basis individual taxpayer attempted to deduct expenses that he had transferred to a newly-formed corporation. The Tax Court denied the deduction to the individual taxpayer rejecting his contention that he was on the accrual basis and that he had "paid" the business expenses in question by transferring them to the corporation.[42] In striking down this argument, the court cited *Doggett* and *Citizens National Trust and Savings Bank v. Welch*.[43] Since the issue of deductibility by the corporation had not been presented, the court did not decide whether the corporation should receive the benefit of deducting the expenses or whether the corporation should be required to apply the payment of the assumed liabilities to its cost of assets.

A recent case with facts similar to those in *Holdcroft*[44] is *United States v. McIver & Smith Fabricators, Inc.*[45] Here the court remanded to determine whether the payment of a contingent obligation of a predecessor business should be a deduction of the transferor corporation and said:

> If the corporation at its inception assumed a contingent obligation to pay . . . it is that assumption of liability which obligated the corporation and not any subsequent legitimate business purpose. In other words, the corporation did not have to pay because of the unfavorable judgment or because its directors deemed payment advisable, but rather the corporation paid because it assumed the obligation when it became incorporated. If . . . factual inquiry reveals a primary purpose other than the acquisition of property, the court may properly allow a deduction to the corporation if all of the requirements of Title 26, U.S.C., Sec. 162, are met, *i.e.*, whether "ordinary", "necessary", "paid or incurred during the taxable

41. 39 T.C. 553 (1962).
42. *Id.* at 567.
43. 119 F.2d 717 (9th Cir. 1941). In *Citizens Nat'l Trust*, expenses of a predecessor corporation were disallowed on the ground that the predecessor, which used the cash basis method of accounting, did not pay the expenses. From the facts of the case, it appears that the Commissioner actually permitted the successor to deduct the pre-consolidation expenses. However, the court did not accept the predecessor's theory that the successor paid the expenses as agent for the predecessor, and that accordingly the predecessor should be able to deduct the expenses even though it did not pay them. The *Citizens Nat'l Trust* case is interesting because it holds that a "non-existent corporation" (*i.e.*, the predecessor which went out of existence after the consolidation) cannot have an agent. Perhaps this explains why the agency theory has not been applied to situations where promoters act on behalf of to-be-formed, but "non-existent" corporations. Nevertheless, because of its unusual facts, the *Citizens Nat'l Trust* case holds scant applicability to the pre-incorporation deduction problem.
44. *See* note 36 *supra*, and accompanying text.
45. 418 F.2d 589 (5th Cir. 1969).

year", and "in carrying on any trade or business."[46]

While the decision of the case on remand was not reported, the instructions of the court hold out fresh hope that judicial consideration will be given to the possibility that liabilities assumed may be deducted under Section 162 by the transferee corporation.[47]

The cases discussed in this section on deductions for liabilities assumed in Section 351 are marked by distinguishing fact situations but can be summarized as follows:

(1) The *Holdcroft* rule which requires assumed liabilities to be capitalized (with the result of no current deductions or increase in depreciable basis) has been eroded by at least one case.

(2) If the corporation can make a good showing that current business motives—not a legal obligation—motivated the payment of a predecessor's liability, then a deduction for the payment thereof may be allowed.

(3) Judicial notice has been taken of the problem that *someone* ought to be able to deduct liabilities which are transferred.

Meeting the Test of "Carrying on any Trade or Business"

Even if pre-incorporation expenses can be attributed to the corporation as having been "paid or incurred" during the taxable year,[48] Section 162(a) imposes the further requirement that the expenses be paid or incurred in "carrying on any trade or business."[49]

Expenses which have been incurred by companies in the developmental stage may be described as "pre-operating" expenses because they are incurred by corporations which have not begun operations of the business for which they were created.[50] Thus, a new corporation has the burden of providing that (1) pre-incorporation expenses are attributable to its taxable

46. *Id.* at 596-97.

47. *See also* Estate of Walling v. Comm'r, 373 F.2d 190 (3d Cir. 1967), *rev'g* 45 T.C. 111 (1965), wherein the court remanded the case for an allocation of repair expenses between the transferor partners' individual returns and the corporation's return. The partners had agreed to pay for a repair expense as a condition to the Section 351 transfer of barges to the new corporation. The repairs were not actually made until after the barges were transferred to the corporation and after the date of incorporation. The court suggested the possibility that the repairs might relate to operations of the barges after the transfer as well as before the transfer and called for an allocation pursuant to Section 482. This case has limited application due to the nature of the expenses and because expenses for the repairs were not actually incurred prior to the date of incorporation.

48. IRC § 162(a).

49. *Id.*

50. *See* Wharton, *Accounting and Reporting for Companies in the Development Stage*, 130 J. ACCOUNTANCY 39 (1970), for a recent discussion of financial accounting treatment of pre-operating expenses. *See also* Erbacher, *Start-Up Costs: Are They*

year, and (2) it was carrying on a trade or business when the expenses were incurred—*i.e.*, that the expenses were not "pre-operating" expenses. Of course if successful application of the *Camp Wolters* and *Canal Navigation & Trading* theories[51] is accomplished on the issue of timing, the only problem remaining is meeting the "carrying on any trade or business" test.

In *Radio Station WBIR, Inc.*[52] and *World Publishing Co. v. Commissioner*,[53] payments made in advance of obtaining broadcasting licenses were denied as deductions on the grounds that the respective taxpayer corporations were not "carrying on a trade or business" when the payments were made.

Another broadcasting case, *Richmond Television Corp. v. United States*,[54] held that training and other pre-operating expenses incurred by a corporation prior to the time it received a television broadcasting license from the Federal Communications Commission were not deductible. The denied expenses were principally salaries paid to a trained staff assembled in advance to permit the station to be operational immediately after obtaining the license from the FCC. The court viewed these expenditures as capital in nature, describing them as "the acquisition of a capital asset whose value to the taxpayer would continue for many years, even though from time to time individual staff members could be expected to leave its employ."[55]

However, an express company's pre-operating expenses were held to be deductible in *Southeastern Express Co.*[56] Although the *Southeastern Express* case has not been mentioned in later Tax Court cases, neither has it been overruled.[57] The company, which incurred administrative expenses for several months prior to the date it began operations, was allowed to deduct those expenses against revenue received after it began operations. The

Deductible by a Corporation for Federal Income Tax Purposes? 48 TAXES 488 (1970); Solomon, *Tax Treatment of Pre-Opening Expenses*, 46 TAXES 521 (1968).

51 *See* text accompanying notes 11-16, *supra.*

52. 31 T.C. 803 (1959).

53. 299 F.2d 614 (8th Cir. 1962), *rev'g* 35 T.C. 7 (1960).

54. 345 F.2d 901 (4th Cir. 1965).

55. *Id.* at 907. *See also* Richmond Television Corp. v. United States, 354 F.2d 410 (4th Cir. 1965), *on remand from* 382 U.S. 68 (1965), where the corporation's later attempt at claiming amortization of the capital asset thus created by the pre-operating expenditures was unsuccessful. The circuit court denied the amortization benefit on the ground that the costs represented an asset with an unlimited useful life.

56. 19 B.T.A. 490 (1930).

57. Weissman, *supra* note 15 at 692, comments that "[t]he decision in *Southeastern* seems to be based on an unwarranted and erroneous conception of what is encompassed by the phrase 'organization expenses'. Clearly it was intended to include only the expenses of creating the corporate entity and ought not to be stretched to include expenses incurred subsequent to incorporation even though arising preparatory to the conduct of business."

express company was incorporated in October, 1920. In its tax return for 1921, it deducted expenses incurred for traveling, postage, stationery, salaries of clerks, and other miscellaneous expenses incurred during the period January 1, 1921 to May 1, 1921. The Board of Tax Appeals allowed these expenses, which were clearly pre-operating in nature, even though the company did not begin carrying express packages until May 1, 1921. The Board was careful to identify and require capitalization of the non-deductible portion of the expenditures which were related to forming the corporation and selling capital stock. The Internal Revenue Service acquiesced in the part of the decision dealing with the permitted deductibility of pre-operating expenses.[58] It appears that the factor distinguishing this case from the broadcasting cases previously cited is that the pre-operating expenses were incurred in the same taxable year in which operations began and income was first received.

In *Petersburg Television Corp.*[59] the Tax Court permitted the deduction of expenses incurred during the taxpayer's fiscal year which ended August 31, 1955. The court limited the deductions to the period after September 29, 1954, the date on which the corporation was granted a construction permit by the Federal Communications Commission. This holding is noteworthy since the corporation did not begin revenue-producing broadcasting operations until August 15, 1955, just 16 days before the end of the taxable year ended August 31, 1955.

Thus, based on *Southeastern Express* and *Petersburg Television* it seems that so long as a corporation begins to carry on operations, *i.e.*, produce revenue, within a taxable year, there is a possibility that all the expenses incurred in the year in which income is first received from operations will be deductible in that first year of actual operation.[60]

The *Camp Wolters* and *Canal Navigation & Trading* decisions allowed the deduction of pre-operating expenses incurred during the pre-incorporation period. In these cases the span of time consisting of the period during which the pre-incorporation expenses were incurred and the initial short taxable year of the corporation did not extend beyond one year.[61] However, it is clear from *Richmond Television* and *Petersburg Television* that pre-opera-

---

58. X-1 CUM. BULL. 61 (1931).

59. 20 CCH Tax Ct. Mem. 271 (1961).

60. *See* Richmond Television Corp. v. United States, 345 F.2d 901, 904, 908 (4th Cir. 1965), indicating that revenue producing activity is a requirement for "carrying on any trade or business."

61. The facts in *Canal Navigation & Trading* do not disclose whether the services rendered by the promoters were fully performed in the taxable year ending December 31, 1941, or whether they were partially performed in 1940 as well as in 1941. The court

ting expenses incurred before operations begin will not be deductible because that are not incurred in carrying on a trade or business.

To the extent that pre-operating expenses are held not to be current expenses deductible under Section 162, they must be capitalized as the cost of developing the business idea.[62] Presumably the tax benefit from these capitalized expenses, unless they can be proven to have a utility of limited duration, must be deferred until the corporation is liquidated or the related business activity is abandoned.

Thus, the important criterion for the deductibility of expenses incurred in advance of operations is that operations actually begin later in that same taxable year. It makes no difference if the new corporation incurs a loss during its first year of operations. An example of this is *Hillcone Steamship Co.*[63] in which deductions for expenses incurred in quarry leasing and timber cutting businesses were allowed on the following rationale:

> The businesses . . . were actually engaged in during the years here involved. . . . Each of these enterprises proved unprofitable . . . but . . . we conclud[ed] that each was engaged in a business undertaken with the intent to make a profit during the years here in issue . . . .[64]

---

seemingly minimizes this problem by relying on Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930), which permits deductions for compensation for services rendered in a prior year if the obligation to pay compensation is created during the current year.

62. In Mid-State Products Co., 21 T.C. 696 (1954), the taxpayer corporation had been in the egg business for several years. In its taxable year ending November 30, 1941, the corporation incurred salary, travel, telephone and other expenses in connection with the development of a new business—producing dried eggs for the U.S. Government. The expenses related to the development of the contracts for the dried eggs were capitalized and deferred as of November 30, 1941, and deducted by the taxpayer according to a formula based on dried egg production in its taxable years ending November 30, 1942, and November 30, 1943. The court stated:

> Here the expenditures were designed and intended to increase the earning capacity of petitioner beyond that of the shell egg business, for which it was organized and in which it was engaged, by setting up and establishing a new and additional business, namely, that of producing and selling dried eggs in which operations actually began in the next succeeding year.

Id. at 714. The court also denied amortization on the ground that "[n]ot all capital assets are wasting assets." *Id.*

A later case, Hillcone Steamship Co., 22 CCH Tax Ct. Mem. 1096, 1108 (1963), suggested that in *Mid-States Products*, "the taxpayer on its records had capitalized expenditures incurred in preparing to enter a new business." This tends to indicate that when a corporation voluntarily represents through entries in its accounting records that the preoperating expenditures are capital in nature, the corporation will be in a difficult position to argue that the expenditures are current expenses or even amortizable costs for tax purposes.

63. 22 CCH Tax Ct. Mem. 1096 (1963).

64. *Id.* at 1107-08. The Tax Court distinguished this case from *Radio Station WBIR*, 31 T.C. 803 (1959), in which no business (regardless of profitability) was being carried on while expenses were incurred.

To summarize the effect of the series of cases interpreting the "carrying on any trade or business" requirement of Section 162:

> (1) The corporation must have operations in the year it attempts to deduct pre-operating expenses (which may be either pre- or post-incorporation expenses).
>
> (2) A corporation may generate a loss in its first year of operations. Even so, the pre-operating expenses incurred in the first year of operations will be deductible so long as the corporation is "carrying on any trade or business."
>
> (3) A corporation which incurs pre-operating expenses in a year prior to the year it begins operations is not able to deduct the pre-operating expenses. Nevertheless, there may be other avenues leading to deductions. For example, a corporation may attribute its pre-operating expenses in non-Section 351 transfers to the cost of amortizable assets with a determinable useful life. However, this tactic is not free from risk that assets so designated might be held to be non-amortizable.

Conclusion

The deductibility of pre-incorporation expenses depends upon meeting the requirements of Section 162 of the Internal Revenue Code which requires that the expenses be incurred in the taxable year and be the result of carrying on a trade or business.

It would appear that many taxpayer corporations risk losing the deductions for pre-incorporation expenses simply because the expenses are incurred prior to the first taxable year in which operations commence. Since there is neither specific authority in the Internal Revenue Code nor permission in the Income Tax Regulations for the deduction of pre-incorporation expenses, would-be promoters should be advised to incorporate and begin revenue-producing operations within the initial taxable year of the new corporation. A postponement of the date of incorporation or the date upon which operations commence may necessitate litigation by the taxpayer corporation in order to sustain the deduction of expenses incurred in years prior to the year of incorporation or the year in which operations commence.

Wendell W. Wiener